H. UBIT: SALE OF LAND

by
Virginia Richardson and Charles Barrett

1. Introduction

Figures recently published in the Statistics of Income Bulletin[1] show that organizations exempt under IRC 501(a) as organizations described in IRC 501(c)(3) hold land, buildings, and equipment totaling $185.2 billion.[2] These holdings represent approximately one-third of all the assets of such organizations.[3] Organizations described in other sections of IRC 501(c) also have substantial holdings. For example, 65 percent of the assets of organizations described in IRC 501(c)(7) consists of land, buildings, and equipment.[4] Even allowing for the fact that the above figures include equipment, exempt organizations unquestionably own billions of dollars worth of land, improved and unimproved, whether acquired through donation, as an investment, or for use in their exempt purposes. In some states, exempt organizations are major landowners with the corresponding power and perhaps responsibility to shape public policy relating to land issues.

A. Rulings Involving the Sale of Land

Because of their substantial holdings of real property, exempt organizations are often involved in the sale of land. There usually is no problem if an exempt organization is the buyer in a single land transaction; however, issues with respect to unrelated business income arise when an exempt organization plans to sell a land asset. The most difficult issues occur when an exempt organization wants to develop the land prior to sale to maximize its gain on the sale, yet it does not want to cross the line and become involved in unrelated trade or business. Hence, many exempt organizations will request a ruling on the unrelated business income tax consequences of a proposed sale of land. Often, the organization also requests a ruling that the proposed transaction will not affect its exempt status.

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[1] Hilgert, C. and Arnsberger, P., "Charities and Other Tax Exempt Organizations, 1988." Statistics of Income Bulletin, Internal Revenue Service, Summer 1992.

[2] Id. at 61.

[3] Id. at 61.

[4] Id. at 71.

Although there are numerous reasons exempt organizations give for selling land, such as changes within the exempt organization which decrease the utilization of the property, often the result of the sale is increased funding for exempt purposes. If the Service were not to issue a requested ruling, the transaction might not occur, particularly if the exempt organization believes that the transaction could possibly have a negative effect on its exempt status or result in unrelated business taxable income. The result is that the organization would not have the funds from the sale to use for its exempt purposes. Although each transaction requires a highly factual analysis, the National Office has usually been willing to issue rulings on the sale of land and has, over the past 15 years, built up a collection of private letter rulings that are disclosable under IRC 6110.

It should be emphasized that PLR's discussed in this article are cited only as examples and are not to be used or cited as precedent, either for the specific facts noted or in their entirety. Although PLR's cannot be used or cited as precedent, they are useful for providing some insight into an area devoid of case law. It should also be noted that frequently, where proposed adverse positions are adopted by the Service concluding that sales of land will generate UBTI, ruling requests are withdrawn by taxpayers and are unavailable for reference.

B. Scope of Article

This article will primarily address issues arising from the sale of land by IRC 501(c)(3) organizations. In this case, and in the case of most organizations described in IRC 501(c), whether the sale of real property results in unrelated business taxable income depends on IRC 512(b)(5). We will begin our discussion of the unrelated business income tax consequences of a sale of land with an analysis of IRC 512(b)(5). However, in the case of exempt organizations described in IRC 501(c)(7) (social clubs), 501(c)(9) (VEBA's), 501(c)(17) (supplemental unemployment benefit trusts), and 501(c)(20) (qualified group legal services plan trusts), the tax consequences of a sale of land are specifically governed by IRC 512(a)(3)(D). We will briefly discuss this separate treatment, but for further discussion of the sale of land by IRC 501(c)(7) organizations, see the Social Clubs article, in this CPE text. We will also briefly note a special situation involving the treatment of an IRC 501(c)(4) organization.

2. The Law: the Code, Malat v. Riddell, LTR's

A. Statutory Framework

IRC 511 imposes a tax on the unrelated business taxable income of certain tax-exempt organizations, including charitable and educational organizations described in IRC 501(c)(3).

IRC 512(a)(1) defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in IRC 513(a)) regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business computed with the modifications provided in IRC 512(b).

IRC 512(b)(5) excludes from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property other than--

(1) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(2) property held primarily for sale to customers in the ordinary course of the trade or business.

IRC 513(a) defines the term "unrelated trade or business" as any trade or business of an organization subject to the tax on unrelated business income the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt function, subject to certain exceptions.

Some private letter rulings involving exempt organization land sales have cited certain regulations under IRC 513. These include Regs. 1.513-1(c)(1) and 1.513-1(d)(2) which deal, respectively, with whether an activity is "regularly carried on" or "substantially related" for purposes of determining if the activity constitutes an unrelated trade or business within the meaning of IRC 513. However, in many cases, the proposed transaction will constitute a regularly carried on unrelated trade or business, so the relevant reference is IRC 512(b)(5).

B. Malat v. Riddell

IRC 512(b)(5) provides that all gains or losses from the sale, exchange, or

other disposition of property are excluded from the computation of unrelated business taxable income. However, gains from the sale of "property held primarily for sale to customers in the ordinary course of the trade or business" will not be excluded from the computation of unrelated business taxable income. The question then becomes how to determine whether property is held primarily for sale to customers in the ordinary course of trade or business. The legislative history provides no guidance. IRC 512(b)(5) was first added to the 1939 Code, at 1939 IRC 422(a)(5), by Pub. L. 814 in 1950. The language has remained unchanged since its enactment, but the history surrounding its initial passage as well as subsequent reinactments is silent as to what is considered "property held primarily for sale to customers in the ordinary course of trade or business."

In Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Supreme Court defined the standard to be applied in determining whether property is held "primarily" for sale to customers in the ordinary course of business for purposes of IRC 1221. The Court interpreted the word "primarily" to mean "of first importance" or "principally." By this standard, ordinary income would not result unless a sales purpose is of first importance.

At present, there is no guidance from court cases specific to IRC 512(b)(5) and the sale of land.[5] However, as previously mentioned the Service has issued a number of private letter rulings involving sales of land by exempt organizations in which we have held that unrelated business taxable income did not result from the sales.[6]

C. Private Letter Rulings

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[5] Parklane Residential School, Inc., T.C.M. 1983-139, is a general UBI case involving the sale of land by an exempt school. The court held that income from the school's simultaneous purchase and sale of land and apartments constituted unrelated business taxable income within the meaning of IRC 511 and 513. The court found that the simultaneous purchase and sale of real estate was not substantially related to the exercise or performance of the school's exempt function, and constituted an unrelated trade or business within the meaning of Reg. 1.513-1(b). Also, the fact that the school entered into 22 of these transactions over a two year period indicated that the activity was regularly carried on within the meaning of Reg. 1.513-1(c)(1).

[6] In some PLR's that apply IRC 512(b)(5), cases arising under IRC 1221 (1) have been cited. Although these cases (other than Malat v. Riddell, supra) may have some usefulness by analogy, they are not controlling for purposes of IRC 512(b)(5).

For example, LTR 88-22-057 (March 4, 1988) involved an organization exempt under IRC 501(c)(3) and classified as a church under IRC 509(a)(1) and 170(b)(1)(A)(i) that purchased a parcel of property totalling about 139 acres. The land was purchased to accommodate a larger sanctuary and parking area as well as other facilities needed for its religious activities. Approximately one and a half years later, the local Township revised its Master Land Use Plan and, without any action on the church's part, designated a portion of the land for commercial use. Although it did not advertise or place a "for sale" sign on the property, the church began to receive unsolicited offers for the land. The church selected one purchaser who intended to develop an office complex, and sold this purchaser 42 acres.

In this case, the ruling concluded that the property was not characterized as "property held primarily for sale to customers in the ordinary course of the trade or business" for purposes of IRC 512(b)(5). Therefore, the gain from its sale was not taxed as unrelated business income. The ruling cited the following facts: the property was purchased for use in the church's exempt activities; the church made no improvements to the property; the church neither advertised to promote sales, nor listed the property with a real estate agent.

In LTR 93-16-032 (Jan. 25, 1993), a hospital and its supporting organization held substantial amounts of real property. The real properties were leased to individual lessees, cooperatives and condominiums. Because the local government had enacted new legislation which could have affected the value of the properties, the organizations proposed to sell to the lessees. Although independent contractors would be hired to aid in the sales, deposits, drafting documents, and closings, no contractors would be used to promote sales to third parties.

The land was received by bequest and was held for a significant period of time. Based on the recently enacted legislation, it was in the organization's best interest to sell the property to receive fair market value. Finally, the property was not being offered to the public, but rather to the current lessees. The ruling, citing Malat v. Riddell, supra, held that the proposed transactions did not involve property held primarily for sale to customers in the ordinary course of trade or business. Therefore, income from the sale did not constitute unrelated business taxable income.

In another case, TAM 87-34-005 (April 27, 1987), an IRC 501(c)(3) organization's activities included the operation of an orphanage, which was

located on a 60 acre tract of land. Over the years, the orphanage changed from institutional facilities centrally located on the 60 acre tract to a family oriented setting in which children were placed in cottage houses located in the communities in which the children resided. Thus, the organization decided to sell the 60 acres which had decreased significantly in utility for the orphanage, after having held the property for over 80 years.

The organization attempted to have the property rezoned to allow commercial development, but was not successful. Then, it attempted to sell the entire parcel to one buyer. Because of the difficulty of selling the entire property to one buyer, the organization hired an engineer to subdivide the property into 36 lots. As the subdivider, the organization was also required by city ordinance to construct a street as well as curb, gutter, sidewalk, drainage, and water supply improvements. The lots were purchased in large blocks by five different parties. Eight sales occurred over the course of five years, with net receipts from the sales totalling almost $7,000,000.

In this transaction, the sales did not constitute "property held primarily for sale to customers in the ordinary course of business" within the meaning of IRC 512(b)(5), and therefore income from the sales did not constitute unrelated business taxable income. The organization had held the property for over 80 years for the purpose of operating its orphanage. When the organization could not sell the property in one block, it subdivided the land and made the minimum improvements required by city ordinances. The organization hired a real estate developer to market the property rather than marketing the property itself. Finally, the TAM stated that the eight total sales over a five year period were due to difficult market conditions rather than a continuous marketing activity. Although, the land transactions described in the TAM involved a significant amount of development by the organization, other favorable facts were found to be persuasive, and thus the gain from the sales did not constitute unrelated business taxable income.

LTR 90-17-058 (Jan. 31, 1990) involved an organization exempt under IRC 501(c)(3). The organization purchased certain property in 1901 and 1902, for use mainly in farming activities to provide dairy products for another organization that provided education, health care, and social services. Approximately 80 years later, the organization had ceased to farm the property, a portion of which was transferred to another IRC 501(c)(3) organization. The organization then decided to sell the remaining portion of the property, approximately 35 acres, due to the cost associated with carrying the property. A "for sale" sign was placed on the

property. A few years later, after having no success in selling the property, the organization authorized a firm to act as broker for the sale of all or portions of the property. However, due to the cost of developing the property as residential property to comply with local ordinances, no sales occurred. After four years, a real estate developer approached the organization with a plan in which the developer would take care of the improvements necessary to comply with the local ordinances in order to sell the land as residential property; the organization would provide the necessary funds. The developer would also market the properties and act as broker. The property was subdivided into 68 lots, 45 of which were sold.

The LTR concluded that the sale of the property did not give rise to unrelated business taxable income because: 1) the property was purchased many years earlier, and not for the purpose of real estate development; 2) the organization was unable to sell the property for several years; and 3) the real estate developer, who arranged to make improvements to the land for the organization, made only the improvements required by local ordinances.

Both the ruling above and TAM 87-34-005, supra, are similar in that both involved local ordinances that required a certain amount of development of property prior to sale as, respectively, residential property and commercial property. In addition, both organizations also acquired their properties for use in their exempt purposes and held the properties for a significant amount of time. Finally both organizations also unsuccessfully attempted to sell their properties in one block and without development.

Various other private letter rulings also have concluded that specific sales of property do not constitute unrelated business taxable income. The facts in the PLR's range from no development activities whatsoever, such as the church described above, to substantial development in the sale of 45 of 68 lots in LTR 90-17-058, supra. LTR 89-50-072 (Sept. 21, 1989) is one that describes a situation in which the sale of land would generate unrelated business taxable income. In this LTR, the taxpayer set forth various options for selling 260 acres of land. One option was to sell the property outright. Another option was to complete some preliminary development work, such as obtaining permits and approvals, and sell the property in large blocks to a few developers prior to the construction of any improvements. Neither of these options was found to result in unrelated business taxable income to the taxpayer. The option that resulted in unrelated business taxable income consisted of the taxpayer assuming all risks of development and managing the development and marketing process. The development would include design and construction of streets, curbs, gutters, sidewalks, lighting, and

utilities. Finally the taxpayer would subdivide and sell the property to the public. The LTR stated that the sales would not be isolated or casual transactions. The taxpayer's extensive involvement in the subdivision, development, and marketing of the property produced the conclusion that the property was held primarily for sale to customers in the ordinary course of trade or business.

The rationale in the above PLR's begins to provide some insight into the factors to consider in deciding whether specific sales of property by exempt organizations result in unrelated business taxable income or produce income excluded from UBTI by IRC 512(b)(5). These factors lead us to the seemingly inevitable facts and circumstances test.

3. Facts and Circumstances Test

Reg. 1.512(b)-1 provides that whether a particular item of income falls within any modification stated in IRC 512(b) shall be determined by all the facts and circumstances of each case.

LTR 89-01-064 (Oct. 13, 1988) sets forth some factors to consider in determining whether the sale of property has been carried out in the regular course of trade or business. These factors are:

(1) The purpose for which the property was acquired.

(2) The frequency, continuity, and size of sales.

(3) The extent of improvements to the property.

(4) The activities of the owner in improving and disposing of the property.

(5) The purposes for which the property is held.

(6) The proximity of purchase and sale.

These factors have also been listed in other IRC 512(b)(5) PLR's. See, e.g., LTR's 92-47-038 (Aug. 27, 1992) and 90-17-058, supra. Usually, no one factor is controlling. Sometimes, "bad facts" under one factor are outweighed by "good facts" under another factor or vice versa. Also, novel situations may have facts that should be considered even though they do not fall easily into any of the above six

factors. Only after consideration and weighing of all the facts can one make a determination whether the modification in computing unrelated business taxable income under IRC 512(b)(5) applies. However, we will examine each of the six factors in turn in order to come to a clearer understanding of the part each factor plays in the entire facts and circumstances test. As we examine the six factors, it is helpful to compare the actions that a taxpayer in the trade or business of selling real estate would normally take with the actions of the exempt organizations proposing to sell land.

A. Factor Number One: The Purpose For Which the Property Was Acquired

This factor goes to the intent of the organization in acquiring the land that it now proposes to sell. Examples of "good facts," i.e., facts that point toward the conclusion that the sale of property is excluded from unrelated business taxable income, include the fact that the land was purchased for use in specific purposes related to the organization's charitable activities. See, e.g., LTR 88-22-057, supra, in which the land was purchased by the church in order to build a larger sanctuary and parking area as well as various other church related activities. In TAM 87-34-005, supra, the organization acquired property for use in operating an orphanage, and in LTR 90-17-058, supra, the organization purchased property for use mainly as a farm in order to provide dairy products for another charitable organization. In LTR 85-25-001 (Dec. 19, 1984), the land was acquired for use in furtherance of the organization's exempt purposes. Also, in LTR 84-29-100 (April 20, 1984), the organization acquired the property for use as a religious educational facility. Additionally, LTR 82-20-030 (Feb. 12, 1982) describes an IRC 501(c)(3) organization that purchased land both for use in its school purposes and for investment purposes; this fact appears to play a significant role in the ruling's conclusion that the sale was not subject to unrelated business taxable income.

Another example of a good fact is that the real property was received as a gift or bequest. In this instance, an organization typically has played no role in acquiring property. Thus, the organization could have had no business purposes in mind because the organization never intended to acquire the property in the first place. The organization has played a passive role unlike a taxpayer in the trade or business of selling real estate who actively acquires real estate for specific business purposes. See, e.g., LTR's 93-16-032, supra, 93-08-040 (Dec. 2, 1992), 91-50-047 (Sept. 18, 1991), 91-08-043 (Nov. 27, 1990), 91-28-030 (April 15, 1991), and 89-01-064, supra, (organizations selling property received by bequest and held for a significant period of time); LTR 90-03-059 (Oct. 30, 1989) (the

property in question was acquired through a devise); LTR 84-29-100, supra, (along with land acquired for religious educational purposes, additional land was received by bequests); and, LTR 80-08-083 (Nov. 29, 1979, amending LTR's 78-17-124 (January 30, 1978) and 79-05-043 (October 31, 1978)) (factors supporting the favorable ruling include the organization's acquisition of substantially all property to be sold by bequest shortly after the organization's inception).

Examples of bad facts, i.e., facts that point toward the conclusion that a sale of property constitutes unrelated business income, include the purchase of land with no corresponding plan for use in an exempt activity. This fact in itself would not be enough to take a sale of land out of the IRC 512(b)(5) exclusion without reference to the other factors such as the extent of improvements to the property or length of ownership; however, it would be a fact which must be taken into account in the facts and circumstances test. It is unlikely that an organization would admit that the purchase of land was for specific business purposes, so the absence of any intended charitable use would hint at a business purpose.

B. Factor Number Two: The Frequency, Continuity, and Size of Sales

This factor is particularly significant in determining whether the sale constitutes a trade or business that is regularly carried on within the meaning of IRC 512. It can range from a one-time sale of a parcel of land to many sales over a long period. If sales are infrequent, not continuous, and small, the organization will not likely be viewed as similar to a taxpayer in the trade or business of selling real estate. See LTR 91-32-061 (May 15, 1991), in which the sale of land was a one time transaction, and LTR 81-52-127 (Oct. 5, 1981), in which the organization disposed of real property in a single transaction. Conversely, as sales become more frequent, more continuous, and larger, they are more likely to be considered a trade or business that is regularly carried on, comparable to the commercial activity of a taxpayer in the trade or business of selling real estate.

In LTR 92-47-038, supra, a favorable ruling was issued to an organization that planned to sell land in up to 15 sales spread over a five to ten year period. The reason for the number of sales over the time period was that the value of the land was such that it was unlikely a single purchaser would be able to acquire the entire parcel. Also, market conditions dictated this sale process for the organization to receive maximum value, and keep control of the pace and type of development that would occur after the sales.

Similarly, in LTR 90-17-058, supra, where the IRC 501(c)(3) organization was engaged in selling 45 of 68 lots, such sales were deemed to meet the exception from unrelated business income under IRC 512(b)(5). Although this quantity of sales is admittedly significant, external forces essentially dictated the high number of sales. The organization first tried to sell the property in one block but was unsuccessful due to the high cost of developing the property in order to comply with local ordinances. Had these two facts been absent, i.e., 1) the organization had attempted to sell the entire property as a whole, and 2) local ordinances that required certain development prior to sale as residential property, it is possible that the high number of sales in this case would have resulted in unrelated business taxable income. See also TAM 87-34-005, supra, where an organization made eight sales over five years after attempting to sell property in one block. Any case involving sales of large numbers of lots deserves stricter scrutiny to determine whether the facts and circumstances test is met.

LTR 85-25-001, supra, noted that the number of lots resulting from the organization's subdivision was relatively small - 12 in number - and only two lots were sold in 1981, none in 1982, and two in 1983.

Thus, a limited number of sales is usually a "good fact" for purposes of the facts and circumstances test. However, one should not come away with the impression that a set limit applies such as, for example, fifteen sales. Rather, one should keep in mind that factors such as the frequency of sales and cost of the land to be sold and market conditions play a part in the number of sales allowed and the time frame of the sales allowed. If an organization has significant amounts of acreage, or the cost of the land precludes finding one purchaser, then it is more likely that the organization will be permitted to sell the land in more than one transaction, and still comply with the requirements of IRC 512(b)(5).

C. Factor Number Three: The Extent of Improvements to the Property

In evaluating factor number three, the smaller the extent of improvements by the organization to the property, the more likely the sale will come under the exclusion for unrelated business income under IRC 512(b)(5). In LTR 80-43-052 (July 30, 1980), an organization proposed to sell a parcel of undeveloped raw land. The fact that the land had remained undeveloped was significant in determining that gains from the proposed transaction would not constitute unrelated business taxable income. In LTR 85-22-042 (March 5, 1985), the property in question consisted of both developed and undeveloped lands. The developed lands included residential land improved with single-family dwellings or condominium

apartments. However, all the improvements were constructed by unrelated third parties. The absence of development activity by the organization demonstrated that it was not holding property for sale to customers in the ordinary course of trade or business. See also LTR 84-03-053 (Oct. 19, 1983), in which an organization did not participate in the construction of condominiums on the property in question, and LTR 80-45-047 (August 13, 1980), where one of three parcels of land to be sold was a commercial lot in which the potential purchaser had built an office building.

In LTR 91-27-045 (April 9, 1991), the improvement made was the extension of a nearby county road dividing the property. The extension was the result of actions taken by a majority of unrelated surrounding landowners who were instrumental in establishing a taxing authority. This taxing authority then taxed all landowners, including the organization, for the purpose of paying for the construction and development of the roadway.

Thus, it appears that a parcel of property to be sold can have extensive improvements, even to the point of having buildings erected, so long as the organization has had no hand in these improvements. However, there have been instances where an organization was allowed to make certain improvements, and yet the sale was excluded from unrelated business income by IRC 512(b)(5). These situations have tended to fall under the next category, the activities of the owner in improving and disposing of the property. It is possible that an organization might be allowed to make improvements to a property that don't fall into the next category as long as those improvements were related to the organization's exempt purpose and were made prior to any contemplation of a sale.

D. Factor Number Four: The Activities of the Owner in Improving and Disposing of the Property

As with the prior category, the more minimal the activities of the owner in improving and disposing of property, the more likely its sale will be considered to meet the exclusion from unrelated business taxable income under IRC 512(b)(5). This is probably the most difficult factor to consider because this is the area where most exempt organizations tend to push the limit. The greater the number of improvements allowed, the greater the likelihood of maximizing gain from the sale.

In many instances, improvements are made when the exempt organization decides to dispose of the property. See TAM 87-34-005, supra, where the

organization decided to sell property, eventually subdivided the property, and as a result of subdividing, was required by city ordinance to construct a street as well as curb, gutter, sidewalk, drainage, and water supply improvements. See also, LTR 90-17-058, supra, in which the organization subdivided the land and had to make certain improvements required by local ordinances to sell the land as residential property. It is interesting to note that both organizations engaged in subdividing, probably because they first attempted to sell their properties whole and were unsuccessful. In LTR 90-17-058, supra, the organization tried to sell the property whole for several years; a taxpayer in the trade or business of selling real estate probably would not be characterized by such inaction. After such subdividing occurred, local ordinances became operative and required certain improvements. Without these ordinances and the fact that the organizations could not sell the properties whole, it is likely that the extent of improvements made by the organizations above would have resulted in unrelated business taxable income.

In LTR 92-47-038, supra, the organization was allowed to make limited improvements to enhance the sale of the property, specifically, the construction of an 800-foot roadway to provide entry to the property. All other site improvements were to be constructed by various buyers of the property at their expense. The organization did not advertise the availability of its property for sale through its real estate brokers, but adopted a passive marketing approach.

LTR 91-28-030, supra, also involved an organization that wanted some control over the land it proposed to sell. The organization wanted to convert the land into income producing assets to supplement teachers' salaries. It entered an agreement with a developer who would subdivide the property into 14 separate three- acre parcels. The organization retained oversight over the development of the property and had the right to approve all development costs, which were absorbed by the developer, who subsequently recovered this cost from buyers as the land was sold. The developer would also market the property. The organization would have no connection with advertising, marketing, or otherwise attempting to sell the lots. It would retain ownership of the lots until sold. The ruling concluded that while the organization was concerned with receiving a high yield from the sale, it was equally concerned that the property be developed in keeping with the surrounding features of the property. The ruling also stated that the organization's interest in preserving the natural beauty of the tract was not indicative of a normal sales transaction. See also LTR 89-01-064, supra, in which the organization sold property to a developer, but retained control over the land's development; the organization was concerned that the property be developed consistent with its best interests and the interests of the people of its state and that the development would

include recreational, educational and cultural facilities.

In LTR 85-25-001, supra, the organization cleared and surveyed a parcel of land, improved it with streets and water and sewer lines, and subdivided it into twelve lots. Had the organization sold the raw land to a developer, the organization might have been better off financially; however, the organization desired that the land be used for residential purposes to preserve the educational, religious and architectural heritage of its institution. The organization stated that by disposing of the parcel in this manner, it could exercise some control over the type of structures to be built on the land. The ruling concluded that the sale would not result in unrelated business taxable income; in subdividing and selling the lots, the organization retained control over the structures to be built on the land, which would not be used for speculative purposes. Probably an important reason for coming to this conclusion was the fact that the organization had a monetary loss in developing the property. This loss indicates that the organization was more interested in development for the sake of harmony with its surroundings as opposed to development for profit similar to a taxpayer in the trade or business of selling real estate.

Aside from development activities, the lack of marketing of the property by the organization helps differentiate it from a taxpayer in the trade or business of selling real estate. See, LTR 85-22-042, supra, where an organization's lack of promotional or development activity in connection with the proposed sale demonstrated that it was not holding property for sale to customers in the ordinary course of a trade or business; LTR 81-52-127, supra, where aside from no improvement or development activities, no advertising or active solicitation of customers was undertaken for the sale of individual lots; and LTR 80-08-083, supra, where the absence of promotional or development activity and the restriction of offers to current lessees distinguished the sales from taxable activities. Use of real estate brokers or other independent contractors is not determinative. See LTR's 93-16-032 and 93-08-040, supra. Rather, the pertinent facts involve the extent of the activities of the organizations themselves in promoting and marketing the property.

E. Factor Number Five: The Purposes For Which the Property is Held

The purposes for which the property is held differs from the first factor (the purpose for which the property was acquired) in that one looks to the actual use of the property rather than at the intentions of the taxpayer at the time of acquisition. If the land is used in the organization's exempt purposes, this fact will weigh in

favor of the sale being excluded from unrelated business taxable income. In LTR 88-22-057, supra, a church purchased land in order to accommodate a larger sanctuary and parking area as well as other facilities needed for its charitable activities. When a portion of the recently purchased land was designated for commercial use by the local Township, the church decided to sell this portion of the property. It is uncertain whether the land was ever used for its intended purposes. Contrast the organizations in TAM 87-34-005, supra, and LTR 90-17-058, supra, in which the properties sold were used, respectively, for an orphanage and for farming purposes to provide dairy products to another charitable organization. Fortunately for the church in LTR 88-22-057, supra, other facts apparently outweighed the non-use of the property for charitable purposes prior to the sale.

If the property is used as an income-producing asset to fund charitable activities, this fact will also aid in the sale being excluded from unrelated business taxable income. See LTR 85-22-042, supra, where organizations held substantial amounts of real property as investments for the production of income to support charitable activities, and LTR 80-45-047, supra, where land had been held solely for investment purposes since acquisition.

The question whether land has been held for investment rather than for sale to customers in a trade or business, is more difficult to resolve than whether land has been used for some tangible charitable purpose. If the land provides revenue, such as income from rental of the land, this is evidence that the land is being held for investment purposes. However, it is possible that land could be held for investment purposes and yet not produce income during the period it is held. See LTR 90-03-059, supra, in which the organization received property by bequest in 1980 and 1984 and chose to sell it in 1988; the property was considered to have been held as a passive investment, generating no income. A way to distinguish investment property which generates no revenue from property held for sale to customers in a trade or business is by reference to the next factor, the proximity of purchase and sale.

F. Factor Number Six: The Proximity of Purchase and Sale

In evaluating this factor, generally the longer the period between purchase and sale, the more likely the sale will be excluded from unrelated business taxable income. In LTR 90-17-058 and TAM 87-34-005, supra, the land was held for over 80 years prior to disposition. In LTR 90-03-059, supra, the organization received property in 1980 and 1984 and sold it in 1988, yet the property was considered to

be investment property.

Realistically, a taxpayer in the trade or business of selling real estate would not ordinarily purchase property unless the taxpayer believed that profit could be made from its sale. In this respect, all purchases of real property have some sort of investment quality. Sometimes the benefit might be indirect, such as enhancement of the value of adjacent property. What often distinguishes a sale of "investment" property from a taxable sale of property held for sale in a real estate sales business is "turnaround time." In the real estate sales business there is usually a short turnaround time between purchase and resale. In LTR 91-08-043, supra, the organization proposed to sell land that it had received by bequest and held for a significant period of time; this was deemed to be completely contrary to the short turnaround period experienced by a typical buyer and seller of real property.

G. Other Factors

Finally, there are several other factors to consider. These include external factors such as local ordinances, land use laws, market factors, or master land use plans. Also, LTR 81-52-127, supra, lists as a factor to consider the "nature and extent of taxpayer's business." This factor is considered if the organization's charitable activities are such that the sale of land activity is minimal in comparison. There will no doubt be novel situations in the future. The important rule is to consider all the facts that are available, as well as the primary purpose test of Malat v. Riddell, supra.

4. Treatment of IRC 501(c)(4) Organizations

Although the above principles relating to IRC 501(c)(3) organizations apply to all other organizations described in IRC 501(c), except for those specifically covered by IRC 512(a)(3), in the case of IRC 501(c)(4) organizations, there may be instances involving very specific facts when other principles apply. Generally, the rule is that in the majority of cases involving the sale of land by exempt organizations, including IRC 501(c)(4) organizations, the factors discussed above will be controlling in determining whether income from a sale of land constitutes unrelated business taxable income.

However, if an IRC 501(c)(4) organization wishes to develop and sell land in conjunction with some established social welfare purpose, under certain circumstances the factors discussed above may not be applicable. Reg. 1.501(c)(4)-1(a)(2)(i) provides that an organization is operated exclusively for the

promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community, such as by bringing about civic betterments and social improvements.

For example, in one specific set of facts described in LTR 88-29-072 (April 28, 1988), an IRC 501(c)(4) organization was organized to promote and develop the common good and social welfare of a community by engaging in activities to benefit the community. These activities included the improvement, extension, and maintenance of a system of roads, the creation of drainage and erosion control programs, the acquisition and expansion of a water and sewage utility, and the extension of water, sewer, and electric utility lines. These activities were for the purpose of stimulating economic development in the area.

The organization was in the process of acquiring approximately 600 acres of land from a large real estate developer. The land was in a central location within the community. The acquisition would enable the organization to replat the land in conformance with a new land use master plan, without having to deal with numerous individuals. The organization would create a division which would directly construct off-site and on-site improvements, as well as handle land sales upon completion of the development. Additionally, the organization proposed to contract with various experts in the related fields of land development.

The LTR cites Rev. Rul. 64-187, 1964-1 C.B. 187 (Part 1), which holds that an organization that provides loans to purchase and develop land for industrial and commercial usage to alleviate unemployment in areas classified as "redevelopment areas" under the Area Redevelopment Act (Public Law 87-27) is exempt under IRC 501(c)(4). The LTR also cites Rev. Rul. 55-439, 1955-2 C.B. 257, which provides that an organization is exempt under IRC 501(c)(4) that purchases acreage in a certain locality, makes arrangements for water and sewer facilities, and enters into arrangements for the erection and sale of dwellings to individuals in low and moderate income groups.

The ruling concluded that there would be no large scale growth without the organization's intervention due to the fact that the governmental agency designed to develop the area was almost insolvent. The organization also would sell the property for the amount of back taxes only and would not make a profit on the sales. The organization's development plans were thus consistent with its primary goal of developing the area and stimulating economic growth.

Thus, an IRC 501(c)(4) organization would be allowed to purchase,

develop, and sell land as long as these activities are tied to a social welfare purpose rather than a business purpose of profiting from the sale of land. It is also possible that an IRC 501(c)(3) or 501(c)(6) organization could engage in similar real estate activities which might be substantially related to their respective exempt purposes.

5. Treatment of IRC 501(c)(7), 501(c)(9), 501(c)(17), and 501(c)(20) Organizations

As mentioned briefly earlier, the sale of land by IRC 501(c)(7), (9), (17), and (20) organizations is specially governed by IRC 512(a)(3)(D). IRC 512(a)(3)(A) provides special rules for these organizations and defines "unrelated business taxable income" as gross income (excluding exempt function income), less the deductions directly connected with the production of such income. IRC 512(a)(3)(B) defines "exempt function income" as gross income from dues, fees, charges or similar amounts paid by members.

IRC 512(a)(3)(D) provides that if property used directly in the performance of the exempt function of an organization described in subparagraphs (7), (9), (17), or (20) of IRC 501(c) is sold by such organization, and within a period beginning 1 year before the date of the sale, and ending 3 years after the sale date, other property is purchased and used by the organization directly in the performance of its exempt function, gain (if any) from the sale shall be recognized only to the extent that the organization's sales price of the old property exceeds the organization's cost of purchasing the other property.

The Senate Finance Committee Report explains the reasons for enactment of IRC 512(a)(3)(D):

> In addition, the committee's bill provides that the tax on investment income is not to apply to the gain on the sale of assets used for such purposes within a period beginning 1 year before the date of the sale and ending three years after that date. This provision is to be implemented by rules similar to those provided where a taxpayer sells or exchanges his residence (sec. 1034). The committee believes that it is appropriate not to apply the tax on investment income in this case because the organization is merely reinvesting the funds formerly used for the benefit of its members in other types of assets to be used for the same purpose. They are not being withdrawn for gain by the members of the organization. (1969-3 C.B. at 470-471.)

The Committee Report also provided an example of a sale and purchase where application of IRC 512(a)(3)(D) would be considered appropriate: "...where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years." (1969-3 C.B. at 471.)

The sale of land by an IRC 501(c)(7) organization generally does not produce exempt function income and therefore such amounts would be subject to unrelated business income tax under IRC 511. However, IRC 512(a)(3)(D) provides an exception to the general rule of IRC 512(a)(3)(A). If the property sold was used directly in the performance of the exempt function of the organization, the gain will not be subject to unrelated business income tax if it is used to purchase other property used directly in the performance of its exempt function. The legislative history of IRC 512(a)(3)(D) is helpful in interpreting the phrase "used directly." The example cited in the Committee Report indicates that the sale of an organization's clubhouse will qualify for nonrecognition of gain, when the proceeds are used to build or purchase another clubhouse. The Committee Report states that this result is desired because the proceeds are not being withdrawn for gain by the organization.

There have been several cases involving the sale of land by IRC 501(c)(7) organizations:

In Framingham Country Club v. United States, 659 F.Supp. 650, 653 (D. Mass. 1987), the court stated in its alternative rationale that "[a]lthough the plaintiff may have purchased the original 120 acres of land with the intention of providing expanded golf facilities, the plaintiff never actually used the 60 acres in question for that purpose." The land was used for the club's greens keeper house and for storage of equipment. The court stated that it "would hesitate to find, on the basis of this rather inconclusive deposition testimony, that the use of a home by a greens keeper and the storage of some large equipment directly facilitated the performance of the exempt function of the Club."

In Atlanta Athletic Club v. Commissioner of Internal Revenue, T.C.M. 1991-83 (2-28-91) [61 TCM 2011, Dec. 47,195(M)] the Tax Court held, in part, that an IRC 501(c)(7) social club must recognize and report the gain from the sale of certain tracts of land as unrelated business taxable income since the evidence was not sufficient to establish that the land was previously used to further its exempt functions as required under IRC 512(a)(3)(D). The club maintained that

the property was intended to be used for recreation or club purposes. However, the court stated, "section 512(a)(3)(D) does not require that we establish what the intent of the petitioner was. Instead, IRC 512(a)(3)(D) requires that petitioner directly use Tracts A and B for exempt functions prior to its sale." (61 TCM at 2019.) The court found that the only activities which may have occurred on the tracts were running and jogging, and such activities were not sufficient to establish that the club directly used the tracts for exempt functions.

In Atlanta Athletic Club v. Commissioner of Internal Revenue, 980 F.2d 1409 (11th Cir. 1993), the Eleventh Circuit reversed the Tax Court's finding above in holding that the club need not recognize and report as unrelated business taxable income the gain from the sale of the property. In interpreting IRC 512(a)(3)(D), the court found that nothing in the legislative history indicated that the words of the statute have other than their ordinary meaning. The court concluded that activities such as annual "Turkey Trot" races, kite flying contests, fishing contests, and periodic jogging by members conducted by the club on the property constituted a direct use of the property for the pleasure and recreation of the club members within the meaning of IRC 512(a)(3)(D). Evidence of these minimal and sporadic activities was based on recollections of witnesses who provided testimony.

The recent Atlanta Athletic Club case indicates that the use of land by an IRC 501(c)(7) social club prior to sale for pleasure and recreational purposes can be less than direct and continuous use for these purposes. However, there must be at least more than the intent to use the land for social purposes.

Following the Appeals Court opinion, it was decided that Supreme Court review was not warranted, and a petition for certiorari was not filed. However, similar issues should be raised in cases where a strong set of facts is present.

6. New Issue: Taxable Subsidiaries

What if an exempt organization decided to create a wholly owned taxable subsidiary whose sole purpose would be to develop and market a parcel of the exempt organization's land? The organization's gain from the sale of land to its taxable subsidiary would probably not constitute unrelated business taxable income. Potentially, it could reap the benefits of extensive development carried on by its taxable subsidiary. The main issue that arises is whether the activities of the taxable subsidiary could be attributed to the exempt organization thus subjecting the organization to the tax on unrelated business income.

G.C.M. 39598 (Jan. 23, 1987) sets forth a two-part test for determining whether the activities of a subsidiary organization should be attributed to the parent organization. The first part of the test is the requirement that the subsidiary be organized for some bona fide purpose of its own and not be a mere sham or instrumentality of the parent. This requirement does not mean that the subsidiary is required to have an inherently commercial or for-profit activity. Rather, the test is to determine the existence of a business purpose or activity.

The second part of the test set forth in G.C.M. 39598, supra, is the requirement that the parent not be so involved in, or in control of, the day-to-day operations of the subsidiary that the relationship between the parent and subsidiary assumes the characteristics of the relationship of principal and agent, i.e., that the parent not be so in control of the affairs of the subsidiary that it is merely an instrumentality of the parent. Control through ownership of stock, or power to appoint the Board of Directors of the subsidiary will not cause the attribution of the subsidiary's activities to the parent. Similarly, a Board of Directors of a wholly-owned subsidiary that is made up entirely of Board members, officers, or employees of the parent will not cause attribution of the subsidiary's activities to the parent. The factor to be considered is the extent to which the parent is involved in the day-to-day management of the subsidiary, along with the bona fide and substantial purpose of the subsidiary, in determining whether the subsidiary is so completely an arm, agent or integral part of the parent that its separate corporate identity is properly disregarded.

G.C.M. 39598, supra, states that the courts, in considering whether to disregard corporate identity, apply a stringent evidentiary standard that requires clear and convincing evidence of the subsidiary's lack of independent status. Further, G.C.M. 39326 (Jan. 17, 1985) states that the activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent or integral part of the parent.

For federal income tax purposes, a parent corporation and its subsidiary are separate taxable entities so long as the purposes for which the subsidiary is formed are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, where an organization is organized with the bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded

for tax purposes. Britt, 431 F.2d at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the legal entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1106 (5th Cir. 1973).

These cases all stand for the following propositions: 1) that corporate entities generally will be recognized rather than disregarded for tax purposes; and 2) that so long as the purpose of incorporation is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate entity. Only in exceptional circumstances, such as if a corporation is created to contravene the policies of the Internal Revenue Code, will courts ignore the separate existence of corporations. G.C.M. 38940 (December 16, 1982), footnote 3, stated that "...[t]o permit an exempt organization to conduct unrelated trade or business through an agent, and thereby retain a 'passive role,' would emasculate the unrelated business income tax." Possibly, organizations could be considered to be contravening the policies of the unrelated business income tax rules by creating taxable subsidiaries for the development and marketing of real estate, where the subsidiary is an agent of the exempt organization.

However, G.C.M. 39326 and G.C.M. 39598, supra, in line with court cases, clearly show a reluctance to disregard the taxable subsidiary's corporate identity and attribute the subsidiary's activities to the exempt parent organization. It is interesting to note that the G.C.M.'s rely on some court cases in which both the parent and the subsidiary corporations are taxable entities; the taxpayers attempt to attribute the activities of the subsidiaries to the parents in order to avoid a separate tax on the subsidiaries. See National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949), and Britt, supra. However, National Carbide and Britt, supra, both held the subsidiaries to be separate entities, and therefore, taxable. It appears that there is a policy to hold that subsidiary corporations are separate entities from a taxable parent, if the organizational purpose is a business purpose, so that subsidiaries cannot avoid being separately taxed. This policy appears to apply when the parent is a taxable entity, as well as when the parent is an exempt organization.

Whether and under what circumstances an exempt organization has the option of placing all its land development activities within a taxable subsidiary is currently under study. One possible Service position is that the corporate identity of the taxable subsidiary should be disregarded and its activities attributed to the

exempt organization only if 1) the exempt organization appears to have a hand in the day-to-day management of the subsidiary, 2) the subsidiary has the appearance of being the arm, agent, or integral part of the exempt organization, and 3) these facts rise to the level of clear and convincing evidence. Guidance on this issue may be forthcoming in the near future.